Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:5:SF:2:POSTF:158557-01
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VIA U.S. MAIL

date:

to: Internal Revenue Service
Large and Mid-Size Business Division
Attn: David Schwarcz, Team Manager
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from: Paul K. Webb, Attorney (LMSB: Area 5)

subject: **TEFRA Status - [redacted]**

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. §6103. This advice may also contain confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, may be subject to the attorney work product privilege. Accordingly, any recipient of this document, including Examination or Appeals, may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This document may not be disclosed to the taxpayer or its representatives.

This memorandum responds to your request for advice of November 8, 2001, with respect to the above-named entity. This advice relies on facts provided by you to our office. If you find that any of the stated facts are incorrect, please advise us immediately so that we may modify and correct this advice.

This advice is subject to 10-day post-review by the National Office. CCDM 35.3.19.4. Accordingly, we request that you do not act on this advice until we have advised you of the National Office's comments, if any, concerning this advice.

Issues

Issue 1: Whether the partnership known as the [redacted] ("[redacted]") is subject to the I.R.C. § 6221 et seq. Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") audit procedures for its taxable year ending 6/30/[redacted].

Issue 2: *If [redacted] is subject to TEFRA audit procedures and the* partnership will not agree to extend its [redacted] statute of limitations for assessment of tax as to partnership items, how should the Internal Revenue Service examination group ("Examination group") proceed in regards to the I.R.C. § 6223(a) requirement that notice partners be given a notice of beginning of administrative proceedings ("NBAP") 120 or more days before issuance of a Final Partnership Administrative Adjustment ("FPAA").

Summary Answers

Answer 1: [redacted] is subject to TEFRA audit procedures.

Answer 2: Because there is less than 120 days before the expiration of the statute of limitations for assessment of tax and an FPAA, if issued, would need to be mailed before the expiration of the statute of limitations for assessment, the Examination group will not be able to give [redacted] notice partners an NBAP 120 days prior to issuance of the FPAA. Hence, the [redacted] notice partners will have certain rights, set forth below, as provided in I.R.C. § 6223(e). The Examination group should adhere to the directions provided in the I.R.M. Flow-Through Entity Multi-Functional Handbook and issue a Hillcrest letter to all partners entitled to notice under I.R.C. § 6223(a).

Facts

[redacted] ("[redacted]") is currently being audited under Coordinated Industry Case procedures. [redacted] files its Federal tax returns using a fiscal year ending 6/30/XXXX. For its taxable year ending 6/30/[redacted], [redacted] filed a consolidated Federal tax return with a group of subsidiary corporations. One of the subsidiary corporations, The [redacted] ("[redacted]"), was a limited partner in the [redacted] partnership.

[redacted] filed an initial short-year Federal tax return, Form

1065, U.S. Partnership Return of Income, for its fiscal year ending on 6/30/[redacted]. [redacted] also filed an amended Federal tax return for this fiscal year. The only apparent difference between the original and amended returns appears to be reflected on Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request ("AAR"), attached to the amended return. The explanation on the AAR states: "The tax shelter registration number for [redacted] was omitted on the previously filed tax return and is being correctly reported on this amended tax return." The statute of limitations for assessment of tax with respect to partnership items for [redacted]'s fiscal year ending 6/30/[redacted] will expire on 2/5/[redacted].

According to the [redacted] amended Federal tax return and its associated Schedule K-1's, [redacted] is a limited partnership with two partners.[1] [redacted], the limited partner in [redacted], owns [redacted]% of [redacted]'s profits and losses and [redacted]% of [redacted]'s capital. The general partner in [redacted] is [redacted] ("[redacted]-LLC"), a limited liability company. [redacted]-LLC owns [redacted]% of the profits and losses in [redacted] and [redacted]% of [redacted]'s capital.

The Schedule K-1 issued from [redacted] to [redacted] for the taxable year ending 6/30/[redacted] states a claimed $[redacted] ordinary loss. The loss reflected on the Schedule K-1 to [redacted] reduced the income reported on the consolidated Federal tax return for the [redacted] group for its fiscal year ending 6/30/[redacted]. The Examination group auditing [redacted] would like to audit the [redacted] partnership return. The Examination group has not yet issued an NBAP to any [redacted] partners.

The Schedule B attached to [redacted]'s amended Form 1065 states that: (1) [redacted] is a limited partnership, (2) a partner in the [redacted] partnership is also a partnership, and (3) [redacted] is subject to the consolidated audit procedures of I.R.C. §§ 6221-33. Schedule B of [redacted]'s amended Form 1065 designates [redacted]-LLC as the Tax Matters Partner ("TMP").

According to Information Document Retrieval System ("IDRS") data, [redacted]-LLC filed a Form 1065 for the taxable year ending December 31, [redacted]. This [redacted]-LLC return encompassed the same taxable period as the above-mentioned [redacted] partnership return. The IDRS data also includes the following information: (1) [redacted]-LLC reported a business start date of [redacted], (2) [redacted]-LLC had three members during the [redacted] taxable year, and (3) the dividend

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[1]The Examination group has not yet secured the original return for [redacted] for its fiscal year ending 6/30/[redacted] and has only the amended [redacted] return in its possession.

income and ordinary loss reported on the [redacted]-LLC return for [redacted] matches the income and loss numbers on the [redacted] Schedule K-1 issued to [redacted]-LLC.

The Examination team has mailed a letter and Form 872-P to the TMP of [redacted], *requesting a voluntary extension of the statue of* limitations for assessment of tax as to partnership items. However, the Examination group does not know if the extension will be granted.

Analysis

I. [redacted] is Subject to TEFRA Audit Procedures.

In an attempt to simplify procedures for determining the tax liability of individual partners of a partnership, Congress added I.R.C. §§ 6221 through 6232 in the Tax Equity and Fiscal Responsibility Act of 1982. See Pub. L. No. 97-248, § 402, 96 Stat. 324 (1982); see also Transpac Drilling Venture, 1983-63 v. Crestwood Hosps., Inc., 16 F.3d 383, 387 (Fed. Cir. 1994). These sections were added so that the tax treatment of certain partnership items, such as income, loss, deductions, and credits, would be "determined at the partnership level in a unified proceeding rather than in separate proceedings with the partners." H.R. CONF. REP. No. 97-760, at 600 (1982), reprinted in 1982 U.S.C.C.A.N. 1190, 1372; see also Brookes v. United States, 20 Ct. Cl. 733, 737 (1990).

The general rule is that all partnerships required to file a return under I.R.C. § 6031 are subject to the TEFRA audit procedures. See I.R.C. § 6231(a)(1)(A). Small partnerships are excepted from the TEFRA audit procedures, unless they elect to be subject to them under I.R.C. § 6231(a)(1)(B)(ii). For taxable years ending after August 5, 1997, "small partnerships" are defined as those: (1) with 10 or fewer partners, (2) each of whom is an individual (other than a nonresident alien), an estate of a deceased partner, or a C corporation, and (3) none of whom are pass-thru partners. I.R.C. § 6231(a)(1)(B)(i), (a)(9); Treas. Reg. § 301.6230(a)(1)-1(a)(2).[2]

A "pass-thru partner" is defined as any partner which is a partnership, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in a

[2] For taxable years ending prior to August 5, 1997, any partnership which included a C corporation as a partner was a TEFRA partnership. That rule has since been changed by Section 1234 of the Tax Relief Act of 1997.

partnership with respect to which TEFRA proceedings are conducted. I.R.C. § 6231(a)(9); Treas. Reg. § 301.6230(a)(1)-1(a)(2).

Each partnership taxable year is examined separately to determine whether the small partnership exception applies. Temp. Treas. Reg. § 301.6231(a)(1)-1T(a)(4). Accordingly, a partnership may be covered by the TEFRA procedures in one year and not covered in the next due to the application of the small partnership exception.

In substance, I.R.C. § 6231(g)(1) provides that, if, on the basis of a partnership return for a taxable year, the Service reasonably determines that the TEFRA audit procedures apply to such partnership for such year but such determination is erroneous, then the TEFRA audit procedures are extended to such partnership (and its items) for such taxable year and to partners of such partnership. Similarly, I.R.C. § 6231(g)(2) provides that, if, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that TEFRA audit procedures do not apply to such partnership for such year but such determination is erroneous, then the TEFRA audit procedures shall not apply to such partnership (and its items) for such taxable year or to partners of such partnership.

The Internal Revenue Code prescribes the classification of various organizations for Federal tax purposes. Whether an organization is an entity separate from its owners for Federal tax purposes is a matter of Federal tax law and does not depend on whether the organization is recognized as an entity under local law. Treas. Reg. § 301.7701-1(a).

Treasury Regulation § 301.7701-3(a) provides that a business entity that is not classified as a corporation under Treasury Regulation § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8)(an "eligible entity") can elect its classification for Federal tax purposes. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under Treas. Reg. § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. The regulation also provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. With exception to entities created prior to January 1, 1997, unless the entity elects otherwise, a domestic eligible entity is (i) A partnership if it has two or more members; or (ii) disregarded as an entity separate from its owner if it has a single owner. See Treas. Reg. § 301.7701-3 (b)(1), (3). These regulations became effective beginning on January 1, 1997.

In the present case, the Examination group is preparing to audit the [redacted] partnership return for its taxable year ending 6/30/[redacted]. According to the [redacted] partnership return, the [redacted] partnership consists of the [redacted] corporation and the [redacted]-LLC limited liability company. The Service's IDRS information indicates that [redacted]-LLC filed a Form 1065 partnership return for the relevant taxable year. Said IDRS information also reflects that [redacted]-LLC's partnership return reported the Schedule K-1 issued by [redacted] for its fiscal year ending 6/30/[redacted]. Said IDRS information also indicates that [redacted]-LLC was comprised of three members during the relevant period.

Since [redacted]-LLC is comprised of more than one owner it is ineligible to be treated as a disregarded entity.[3] See Treas. Reg. § 301.7701-3 (b)(1), (d)(2). Assuming that [redacted]-LLC is not automatically classified as a corporation under Treasury Regulation § 301.7701-2(b)(1), (3)-(8), the default rule of the regulation provides that it should be treated as a partnership for tax purposes since it is comprised of more than one owner.[4] See Treas. Reg. § 301.7701-3 (b)(1). In fact, by filing a Form 1065 Federal tax return, [redacted]-LLC treated itself as a partnership for Federal tax purposes during the relevant period. As such, [redacted]-LLC is treated as a pass-thru partner for purposes of I.R.C. § 6231(a)(9)(either as a "partnership" or as an "other similar person through whom persons hold an interest in the partnership") and Treas. Reg. § 301.6231(a)(1)-1(a)(2). Since [redacted]-LLC is pass-

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[3] In this case, [redacted]-LLC is clearly not a disregarded entity. Thus, we do not address whether a partner consisting of a single member limited liability company would result in automatic exclusion from the small partnership exception of I.R.C. § 6231(a)(1)(B)(ii).

[4] We have insufficient information to determine whether [redacted]-LLC should have automatically been classified as a corporation pursuant to Treasury Regulation § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8). However, for purposes of this "small partnership" exception analysis, we assume that [redacted]-LLC properly treated itself as a partnership rather than a corporation during the relevant period. If it is subsequently discovered that this classification is incorrect, i.e., that [redacted]-LLC should have classified itself as a C corporation for Federal tax purposes, I.R.C. § 6231(g)(1) would still operate to protect the Service, as explained herein.

thru partner, the small partnership exception to the TEFRA audit procedures is inapplicable. Thus, for its taxable year ending 6/30/[redacted], [redacted] is subject to TEFRA proceedings.

Even if the above assumption and facts regarding [redacted]-LLC were incorrect, the Service can arguably make a reasonable determination that TEFRA audit procedures apply based upon [redacted]'s partnership return. The check-the-box section of the Schedule B attached to the [redacted] return reflects that one of [redacted]'s partners is itself a partnership and that [redacted] is subject to TEFRA proceedings. These combined statements, plus the designation of a TMP on the [redacted] return, should be sufficient to support a reasonable determination that [redacted] is subject to TEFRA proceedings. Thus, if a TEFRA audit of [redacted] is begun and it is subsequently determined that [redacted] should not have been subject to TEFRA audit procedures, the procedures would statutorily be extended to cover the [redacted] audit. See I.R.C. § 6231(g)(1).

II. Beginning a TEFRA Audit with Less than 120 Days before Expiration of the Statute of Limitations.

In the case of a proceeding pursuant to the TEFRA unified audit and litigation procedures of I.R.C. § 6221 et seq., Congress expressly gave any partner the right to participate in the administrative proceeding. I.R.C. § 6224. In order to participate in the proceeding, the partner must be aware of the proceeding. Accordingly, I.R.C. § 6223(a) generally requires the Service to give partners notice of both the beginning (via an NBAP) and completion (via an FPAA) of an administrative proceeding to determine partnership items. The purpose behind this notice provision is to ensure that each partner who is entitled to notice has the opportunity to participate in the administrative proceedings.[5]

In the event the Service fails to provide proper notice of the administrative proceeding, Congress fashioned a remedy for the improper notice. If an NBAP is issued less than 120 days

[5] "Notice partners" are defined as those partners who, at the time in question, would be entitled to notice under I.R.C. § 6223(a). I.R.C. § 6231(a)(9). Section 6223(a) provides that each partner whose name and address is furnished to the Secretary is entitled to notice of the beginning and ending of partnership proceedings. Such partners are not entitled to notice unless the Secretary received sufficient information to determine whether a partner is entitled to such notice at least 30 days before notice is mailed to the TMP. Treasury Regulation § 301.6223 provides additional information regarding notice rights.

before the issuance of the corresponding FPAA, the taxpayer's remedy is set forth in Section 6223(e). Wind Energy Tech. Assoc. III v. Commissioner, 94 T.C. 787 (1990). Though the remedy varies depending upon whether the proceeding is ongoing, generally the taxpayer's choices are: to be bound by the TEFRA proceeding; to have a prior settlement entered between the Service and another partner apply to the aggrieved partner; or to have the aggrieved partner's partnership items converted to nonpartnership items. I.R.C. §6223(e). When partnership items are converted to nonpartnership items, the Service is generally authorized to issue a notice of deficiency to the partner for any tax liability arising out of adjustments to the former partnership items. I.R.C. §6230(a)(2)(A)(ii). Once the notice of deficiency is issued, the case is generally governed by the rules applicable to deficiency cases.[6] Id.

The Service has prepared a Flow-Through Entity Multi-Functional Handbook for use in cases involving TEFRA audit procedures. See I.R.M. 121.5, Chp. 1. The manual, which was updated January 1, 1999, states that:

> (4) Regardless of the amount of time remaining on a TEFRA key case statute of limitations:
>
> a. A[n] [NBAP] must be issued to the TMP and all notice investors ...;
> b. An FPAA must be issued to the TMP at least 120 days after the NBAP is issued to the last notice investor ...;
> c. If less than 120 days remain after issuance of the NBAP, the Service will be considered to not have given timely notice. Since the investor is entitled to an election under I.R.C. § 6223(e)(2) or (3), a "Hillcrest letter" (see Exhibit 1-3, Hillcrest Letter) is sent with the FPAA informing the investor of their right to make an election and the time period for exercising that right. Upon issuance of the FPAA to the TMP, the statute of limitations is held open for a minimum of 150 days plus one year from the date of the FPAA.

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[6] In regards to partnership items converted into nonpartnership items by reason of I.R.C. § 6231(b), the period for assessing any income tax attributable to such items shall not expire before the date which is one year after the date on which such items became nonpartnership items. I.R.C. § 6229(f)(1).

I.R.M. 1.12.10.2(4). As stated in the above-quoted I.R.M. text, Exhibit 121.5.1-3 sets forth the language to be used in a Hillcrest letter.

If not extended, the statute of limitations for assessment of tax resulting from the partnership items of the [redacted] partnership will expire in less than 120 days. I.R.C. § 6229(a). An FPAA, if issued, must be mailed prior to that expiration date in order to suspend the statute of limitations. I.R.C. § 6229(d). As such, absent agreement to extend the statute of limitations date, the Examination group will not be able to issue an NBAP 120 days prior to issuance of an FPAA. <u>See</u> I.R.C. § 6223(a). Thus, the Examination group must proceed as set forth in the above-quoted I.R.M. text and mail all [redacted] notice partners a Hillcrest letter along with any forthcoming FPAA. The Hillcrest letter, I.R.M. Exhibit 121.5.1-3, sets forth each notice partners' rights under I.R.C. § 6223(e).

<u>Conclusion</u>

The [redacted] partnership is subject to TEFRA audit procedures for its taxable year ending 6/30/[redacted].

Absent receipt of an agreement to extend the statutory period for assessment, the Examination group must inform all [redacted] notice partners of their rights under I.R.C. § 6223(e). This can be accomplished by mailing all [redacted] notice partners an FPAA accompanied by a Hillcrest letter.

Please telephone attorney Paul K. Webb at (415)744-9217 if you have any questions regarding this memorandum.

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